



Highlights and Analysis of the Governor's May Revision of the 2007-08 Budget

May 16, 2007
SENATE REPUBLICAN
FISCAL OFFICE



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Budget Briefs

SENATE REPUBLICAN FISCAL OFFICE

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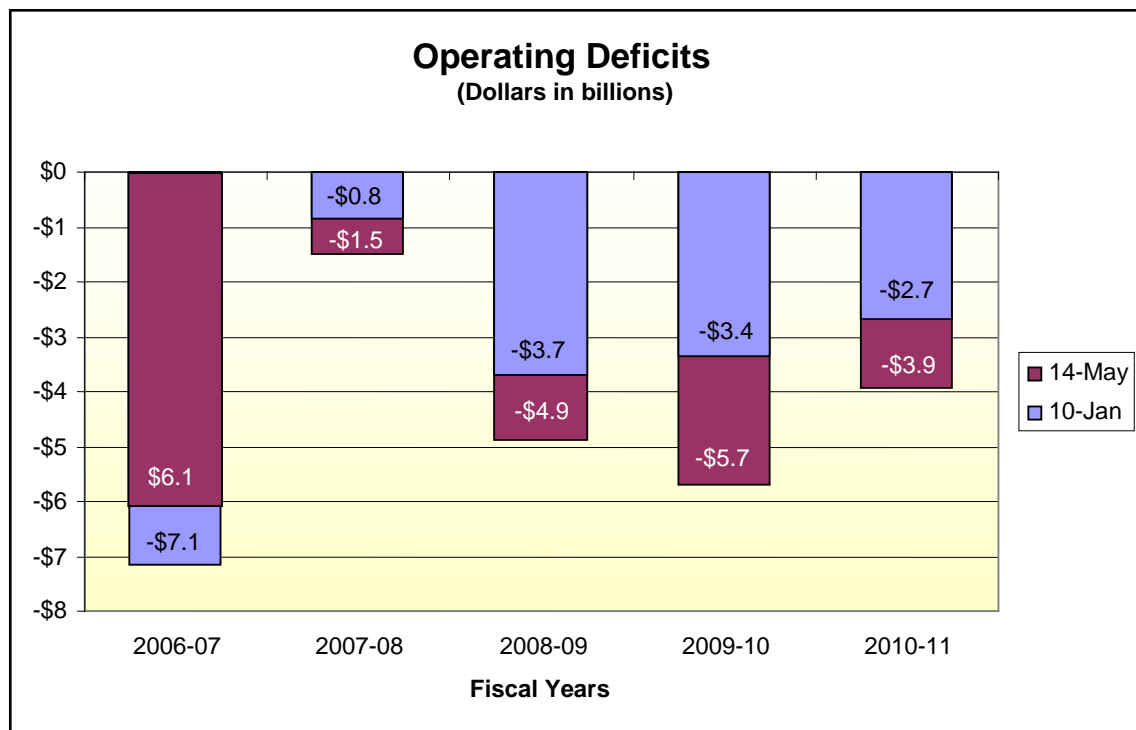
Executive Summary

The May Revision certainly deserves kudos for creativity and “thinking outside the box” in terms of seeking budget solutions that do not necessitate program reductions or new taxes. However, as a consequence of seeking painless solutions to the spending problem, it fails to make measurable improvements to the Governor's Budget proposed in January. Because it increases spending in spite of falling revenues, the May Revision leaves considerable room for improvement in moving the state towards fiscal responsibility. The significant one-time revenue transfer (from the Tobacco Securitization Fund) and asset sale (of the EdFund), coupled with the perpetual growth in expenditures, exacerbate the structural budget problems facing the state. The May Revision does not propose significant spending reductions or programmatic reforms to control costs, and General Fund expenditures continue to grow significantly year-over-year. The bottom line is that the operating deficit grows in the budget year and well into the future.

Key Points

- **May Revision Provides More, More, More...More Spending** that is financed by More Borrowing (i.e., \$957 million Tobacco Bonds) and More Financing Schemes (i.e., the \$980 million Sale of the EdFund), and because these revenue generators are one-time in nature they do not address the structural deficit.
- **No New Taxes** - The Governor's May Revision does not include any new taxes.
- **Spending Up** - General Fund spending is up about \$624 million as compared to the Governor's January Budget proposal. However, Budget Year General Fund spending is **\$2.5 billion above the 2006 Budget Act**.
- **Revenue Down** - Absent the transfer of Tobacco Bond Proceeds and the EdFund sale, General Fund revenue projections are **down by nearly \$1.4 billion** in the budget year compared to the Governor's January Budget.

- **Operating Deficit Persists** - The 2007-08 Gross Operating Deficit is **\$1.5 billion**. The deficit grows to nearly \$5 billion in 2008-09, \$1.2 billion larger than it was in the January budget proposal, because of all the new spending and one-time financing schemes.



- **Ignorance is Bliss** - The Governor's May Revision proposes to maintain the 2007-08 General Fund reserve at approximately \$2.2 billion, but it **ignores budgetary pressures** such as the Prison Receiver requests and the pending Correctional Officers' Salary Increase. It also assumes the Democrats do not reject hundreds of millions of dollars in welfare program spending cuts while approving the Indian Gaming Compacts.
- **Maintains Pre-Payment of Budgetary Debt** – The May Revision continues the Governor's January proposal to pre-pay \$1.6 billion of the balance owed on the Economic Recovery Bonds. Although it is in effect **utilizing borrowed funds to re-pay borrowed funds** because of the operating deficit.
- **No Lotto Jackpot** - The Lottery-for-lease deal is **not** assumed in the May Revision Budget revenue numbers, and there is no specific proposal on the table.

Revenues

The May Revision proposes no new tax increases. The Administration's revenue projection (including the Budget Stabilization Account transfer) increases to \$96.2 billion in 2006-07 and \$102.3 billion in 2007-08. This represents an increase of approximately \$1.2 billion in 2006-07 and a decrease of \$24 million in 2007-08 as compared to the Governor's January budget proposal. However, these revenue totals are misleading because they rely on one-time transfers from Tobacco Bond proceeds and the EdFund financing scheme. **Absent these one-time transfers, the current year increase in revenues is only \$566 million and budget year revenues are down nearly \$1.4 billion.**

General Fund Revenues				
(Dollars in millions)				
2006-07 Revenues	Governor's Budget	May Revision	Change	%
Personal Income Tax	\$52,042	\$52,243	\$201	0.4%
Sales Tax	\$27,775	\$27,787	\$12	0.0%
Corporation Tax	\$10,311	\$10,717	\$406	3.9%
Other Revenues and Transfers	\$4,391	\$4,338	-\$53	-1.2%
Total, Traditional Sources	\$94,519	\$95,085	\$566	0.6%
<i>Transfer of Tobacco Securitization Bonds</i>	\$0	\$600	\$600	
<i>Transfer to Budget Stabilization Account</i>	\$472	\$472	\$0	0.0%
Total, All Sources	\$94,991	\$96,157	\$1,166	1.2%

2007-08 Revenues	Governor's Budget	May Revision	Change	%
Personal Income Tax	\$55,598	\$55,236	-\$362	-0.7%
Sales Tax	\$29,347	\$28,841	-\$506	-1.7%
Corporation Tax	\$10,816	\$11,053	\$237	2.2%
Other Revenues and Transfers	\$5,516	\$4,786	-\$730	13.2%
Total, Traditional Sources	\$101,277	\$99,916	-\$1,361	-1.3%
<i>Transfer of Tobacco Securitization Bonds</i>	\$0	\$357	\$357	
<i>Revenue from Sale of the EdFund</i>	\$0	\$980	\$980	
<i>Transfer to Budget Stabilization Account</i>	\$1,023	\$1,023	\$0	0.0%
Total, All Sources	\$102,300	\$102,276	-\$24	0.0%

Revenue projections from traditional major General Fund sources (i.e., PIT, SUT, and CT) are **down by about \$243 million** for current year and budget year combined compared to the Governor's January Budget. In order to make up that General Fund loss, the Administration has proposed two major one-time solutions that fund increased expenditures, but do not address the structural deficit. These solutions include:

- **Tobacco Bond Proceeds (\$957 million)** – The Governor proposes to transfer \$600 million from the Tobacco Securitization Fund to the General Fund in 2006-07 and \$357 million in 2007-08. This revenue is derived as a result of Chapter 641, Statutes of 2006 (AB 1141/Budget), which authorized the state to sell residual interests on Master Settlement Agreement payments. The Department of Finance initially estimated that this would generate \$900 million (**additional long-term debt**), but in fact the sale generated \$1.3 billion. At that time it was understood that these funds would be used to offset the cost associated with the “CTA Settlement”, which is roughly \$2.9 billion. Clearly, using these funds to cover new spending (or pre-pay debt or shore up the reserve) **creates a significant funding hole in future years** as the CTA Settlement comes due.
- **EdFund (\$980 million)** - The Administration indicates that selling California's student loan guarantee agency (EdFund) to a private company could produce a significant **one-time** financial benefit to the state (estimated at \$980 million after adjusting for the **lost annual revenue stream of \$20.3 million**) without adversely affecting students. The potential merits of this proposal depend upon the details and structure of the sale. It would be fiscally irresponsible if the one-time funds generated by the sale of this valuable asset were simply used to support ongoing spending.

Expenditures

The May Revision proposes to increase General Fund expenditures in 2007-08 by \$1.5 billion, or 1.5 percent, over the revised level of expenditures in 2006-07. However, General Fund expenditures are actually growing much quicker if compared to the 2006 Budget Act appropriations - current year expenditures have grown by more than \$1 billion and budget year expenditures have grown by more than \$2.5 billion. ***As a result, total spending over the two years is up by more than \$3.5 billion relative to the 2006 Budget Act.***

General Fund Expenditures By Agency (Dollars in millions)					
2006-07 Expenditures	2006 Budget Act	Governor's Budget	May Revision	Change From Budget Act	%
Higher Education	\$11,368	\$11,368	\$11,441	\$73	0.6%
K-12 Education	\$40,510	\$40,016	\$40,197	-\$313	-0.8%
Corrections and Rehabilitation	\$8,751	\$9,236	\$9,385	\$634	7.2%
Health and Human Services	\$29,304	\$29,820	\$29,668	\$364	1.2%
Environmental Protection	\$88	\$92	\$88	\$0	0.0%
Resources	\$1,826	\$2,161	\$2,096	\$270	14.8%
Business, Transportation & Housing	\$3,029	\$3,026	\$3,019	-\$10	-0.3%
State and Consumer Services	\$576	\$602	\$613	\$37	6.4%
Legislative, Judicial, Executive	\$3,417	\$3,505	\$3,522	\$105	3.1%
General Government	\$2,293	\$2,206	\$2,127	-\$166	-7.2%
Labor and Workforce Development	\$99	\$105	\$108	\$9	9.1%
Total	\$101,261	\$102,137	\$102,264	\$1,003	1.0%

2007-08 Expenditures	2006 Budget Act	Governor's Budget	May Revision	Change From Budget Act	%
Higher Education	\$11,368	\$12,002	\$11,994	\$626	5.5%
K-12 Education	\$40,510	\$40,512	\$41,367	\$857	2.1%
Corrections and Rehabilitation	\$8,751	\$10,043	\$9,969	\$1,218	13.9%
Health and Human Services	\$29,304	\$29,875	\$29,907	\$603	2.1%
Environmental Protection	\$88	\$86	\$90	\$2	2.3%
Resources	\$1,826	\$1,472	\$1,687	-\$139	-7.6%
Business, Transportation & Housing	\$3,029	\$1,588	\$1,650	-\$1,379	45.5%
State and Consumer Services	\$576	\$575	\$576	\$0	0.0%
Legislative, Judicial, Executive	\$3,417	\$3,793	\$3,864	\$447	13.1%
General Government	\$2,293	\$3,077	\$2,543	\$250	10.9%
Labor and Workforce Development	\$99	\$118	\$118	\$19	19.2%
Total	\$101,261	\$103,141	\$103,765	\$2,504	2.5%

As is evident in the tables above, and further highlighted in the pages that follow, notions of “restraint in overall spending” are exaggerated. The persistent volatility of the revenues, as evidenced by the need for one-time “solutions” that are used to support current and budget year expenditures, warrant considerable caution and should not be relied upon to fund ongoing programs.

Education

Proposition 98 Guarantee Up Slightly From Governor's Budget. An increase in current year revenues has pushed the 2006-07 Proposition 98 minimum guarantee of funding for education up by about \$372 million, from \$55 billion to \$55.4 billion. The 2007-08 guarantee rises as well, by about \$104 million, from \$57.5 billion to \$57.6 billion, or about four percent over the current year estimate.

The table below details the changes in proposed Proposition 98 funding and in estimated K-12 per-pupil expenditures between the January Governor's Budget and the May Revision.

Proposition 98 and Per-Pupil Funding			
2006-07 (\$ in billions)	Jan 10 Budget	May Revision	Difference
Proposed Prop 98 Funding	\$55.022	\$55.395	\$0.373
General Fund	\$40.812	\$41.192	\$0.380
Local property taxes	\$14.210	\$14.203	(\$0.007)
Minimum guarantee	\$55.022	\$55.395	\$0.373
Over/underappropriation	\$0	\$0	\$0
(actual \$)			
K-12 Prop 98 per-pupil funding	\$8,293	\$8,269	(\$24) ^{a/}
K-12 total per-pupil funding	\$11,240	\$11,225	(\$15) ^{a/}
<small>a/ decrease is due to an increase in estimated average daily attendance (ADA) since January</small>			
2007-08 (\$ in billions)	Jan 10 Budget	May Revision	Difference
Proposed Prop 98 Funding	\$57.462 ^{b/}	\$57.566 ^{b/}	\$0.104
General Fund	\$41.817	\$41.930	\$0.113
Local property taxes	\$15.645	\$15.636	(\$0.009)
Minimum guarantee	\$57.462	\$57.566	\$0.104
Over/underappropriation	\$0	\$0	\$0
(actual \$)			
K-12 Prop 98 per-pupil funding	\$8,569	\$8,681 ^{c/}	\$112
K-12 total per-pupil funding	\$11,584	\$11,562	(\$22) ^{d/}
<small>b/ includes roughly \$630 million for home to school transportation c/ falls to \$8,636 if the \$268 million provided for the Quality Education Improvement Act (CTA settlement) is excluded d/ decrease is due mostly to falling federal funds</small>			

Technical Error Could Eliminate New Ongoing Proposals. The May Revision assumes that there will be significantly more “room” within the guarantee to fund new K-12 programs, the most notable of which are shown in the table below. However, the Legislative Analyst believes that the Governor has underestimated the amount necessary to fund school apportionments (revenue limits) in 2007-08 by failing to carry forward about \$366 million associated with 2006-07 equalization. If this is so, most if not all of the ongoing funding outlined in the table below will need to be redirected to apportionments and ***will therefore be unavailable for new programs.***

K-12 Ongoing Proposals at May Revision	
(Dollars in millions)	
-\$100.0	High Priority Schools - savings
\$50.0	Career technical education teachers
\$50.0	A through G course teachers
\$50.0	Preschool expansion - phase two
\$25.0	Career technical education counselors
\$24.9	School meal reimbursements
\$12.0	Encorps (train retirees as teachers)
\$11.1	Fresh Start (fruits & vegetables)
\$9.0	School safety resource officers
\$8.7	County offices of education - high school exit exam workload
\$7.5	Recruit math and science teachers
\$3.0	Personnel management assistance teams
\$2.5	Principal training
\$2.0	Alternative teacher salary schedules
-\$3.5	Other (various)
\$152.2	Total

Fund Shift “Solutions” Expand. The May Revision continues the Governor’s January proposal to shift about \$630 million from the Public Transportation Account to the General Fund in 2007-08 to backfill Proposition 98 expenditures for home-to-school transportation. However, the Governor no longer proposes to “rebench” the guarantee downward. Instead he proposes now to simply transfer funds from the PTA to the General Fund to backfill these costs. A new control section in the budget act would provide the authority for this transfer. In addition to the 2007-08 shift, the May Revision proposes a current-year shift of \$200 million. Lastly, the May Revision continues a \$269 million shift of CallWORKS child care into Proposition 98. ***These shifts create about \$1.1 billion in General Fund savings.*** If the Legislature rejects them, it will have to find these savings elsewhere in the budget.

\$400 Million For One-time Uses. In addition to the augmentations in ongoing funding shown in the table above, the May Revision proposes funds for a variety of one-time purposes, as follows:

K-12 One-Time Proposals at May Revision	
(Dollars in millions)	
\$100.0	School safety pilot (\$ block granted over 3 yrs)
\$96.0	Williams emergency repair program
\$65.0	CalPADS pre-implementation work
\$50.0	K-12 career technical equipment
\$48.1	Supplemental instruction deficiencies
\$20.0	English language learner instructional materials
\$20.7	Other (various)
\$399.8	Total

Higher Education

Governor Proposes to Privatize EdFund. EdFund is a non-profit auxiliary organization of the California Student Aid Commission (CSAC). On behalf of the federal government, it serves as the guarantor of student loans in California and elsewhere. In recent years, mostly as a result of federal revenue streams, EdFund's Student Loan Operating Fund has been sufficiently healthy to enable it to subsidize some of the CSAC's student financial aid operations. Federal revenues have recently declined, however, and as part of the May Revision, the Governor proposes to sell EdFund to reap a one-time benefit of about \$1 billion and to backfill its support of CSAC with about \$20 million from the General Fund.

Issues to consider regarding this sale include:

- What constitutes a fair price for EdFund?
- For what purposes would the revenue from its sale be spent?
- Will California's students receive the same level of service from the new operator as they do now from EdFund (e.g., waivers of loan origination fees)?

Community Colleges. The May Revision proposes a variety of adjustments to one-time and ongoing funding for the Community Colleges, the most notable of which are summarized in the chart below:

Community College Adjustments at May Revision	
(Dollars in millions)	
One-time funding rises	
\$50.0	Career technical equipment
\$50.0	Nursing equipment
\$47.5	Deferred maintenance
\$2.7	High-speed internet at all campuses
\$2.5	Textbook assistance for needy students
\$152.7	Total
Ongoing funding falls	
-\$81.6	Conform growth funding to expected enrollment
\$25.2	Increase COLA from 4.04% to 4.53%
\$10.0	Augment matriculation services
-\$4.6	Other / various / technical
-\$51.0	Total

UC and CSU. The May Revision proposes relatively few changes to the budgets of UC and CSU. It proposes to augment UC's budget by \$2 million in Proposition 99 funds for one-time tobacco-related research, and it states an intent to reinstate employer contributions to UC's employee retirement fund, which were suspended for several years while the fund reserves were surging. For CSU, the May Revision proposes \$3.6 million to support an additional 340 undergraduate nursing slots.

Public Safety and Judiciary

Anti-Gang Measures. The May Revision includes several proposals totaling \$25 million in the Office of Emergency Services (OES) and in the Department of Corrections and Rehabilitation (CDCR) to fight gang activity in both local jurisdictions and in state prisons.

Anti-Gang activities proposed in the May Revision include:

- **Local Funding for Anti-Gang Programs.** \$7 million General Fund to be administered by OES as a grant program.
- **Federal Anti-Gang Grants.** \$4.9 million in federal funds for four new anti-gang grants.
- **State Anti-Gang Coordinator.** \$446,000 to establish a state anti-gang coordinator in OES.
- **Criminal Intelligence Analysis Unit.** \$8.5 million in CDCR to implement a sophisticated gang intelligence gathering and analysis system. This includes a \$5.5 million grant from the Office of Homeland Security.
- **Regional Gang Task Forces.** \$3.3 million for CDCR to create three pilot task forces in Los Angeles, the Bay Area, and the Inland Empire to disrupt criminal activity both in prison and in the community.
- **Project IMPACT.** \$820,000 to operate Project IMPACT (Incarcerated Men Putting Away Childish Things), a gang diversion program in Juvenile Institutions.
- **Increased Fine Revenue.** The May Revision also includes a proposal to increase the state surcharge by \$2 on base fines. This will result in fees being \$26 for every \$10 in fines. This increased levy is projected to result in new revenue to the General Fund of \$14 million to be used to fund anti-gang activity. This proposal would also shift responsibility for collecting fines, fees, and penalties from the counties to the courts.

Judiciary. The May Revision includes \$36.6 million to address security needs for the Trial Courts based on the recommendations of the Court Security Working Group.

Office of Homeland Security. The May Revision proposes \$177.6 million Proposition 1B funds to establish the Port Security Grant Program (\$76.1 million) and the Transit Security Grant Program (\$101.5 million).

Office of Emergency Services. In addition to the anti-gang activities mentioned above, the May Revision includes \$4 million Restitution Fund to provide four Internet Crimes Against Children Task Forces.

Department of Justice. The May Revision includes a shift of \$11.2 million from the DNA Identification Fund to the General Fund to reflect revenue collections being less than expected. There is also a proposed increase of \$3 million from the Restitution Fund for the California Witness Protection Program.

Office of the Inspector General. The May Revision includes \$810,000 for the Office of the Inspector General to implement the California Rehabilitation Oversight Board as required in the Public Safety and Offender Rehabilitative Services Act of 2007 (AB 900).

Department of Corrections and Rehabilitation

The May Revision includes \$113 million for increased support costs in the Department of Corrections and Rehabilitation (CDCR). Changes in the May Revision include:

Population Funding

Adult Population Estimate. The May Revision proposes a net increase of \$3.9 million in the current year and a decrease of \$47 million in the budget year for adult population estimates. However, this does include funding not strictly associated with population growth.

The estimated current year adult inmate institution Average Daily Population (ADP) is 172,369, a decrease of 1,032 from the Governor's Budget, and adult parole ADP of 120,717, an increase of 1,569. The estimated budget year institution ADP is 174,300, a decrease of 3,277 from the Governor's Budget, and a parole ADP of 124,862, an increase of 2,714.

Division of Juvenile Justice Population. The May Revision proposes an increase of \$1.2 million for the current year and a reduction of \$2.5 million for budget year for juvenile population issues. The Division of Juvenile Justice population continues a downward trend and reflects an estimated 2007-08 year-end ward population of 2,340, a decrease of 150 wards from the number projected in the Governor's Budget. The juvenile parole population is estimated to be 2,385, a decrease of 20.

Juvenile Facility Closures. The Department proposes to begin the closure of the Dewitt Nelson Youth Correctional Facility in Stockton due to declining population. This will result in savings of \$1.7 million in 2007-08 and ongoing savings of \$28 million. Additionally, if the Governor's plan to shift low-level juvenile offenders from the state control to local control is adopted, the Department would close the Herman G. Stark Youth Correctional Facility in Chino.

Other Population Related Requests

Local Assistance Funding. The May Revision also includes \$16.9 million in local assistance funding, as follows:

- **DA Costs.** \$7.8 million to fund shortfalls from 2006-07 in reimbursements to counties for costs of prosecuting prison crimes
- **Daily Jail Rate.** \$1.5 million as a result of increasing the Daily Jail Rate paid to counties for incarcerating parolees from \$71.57 a day to \$77.17.
- **Pitchess.** \$6.1 million as a result in delays in moving inmates out of the Pitchess Detention Center in Los Angeles County.

Peace Officer Recruitment. The May Revision also requests funding of \$18.7 million to increase peace officer recruitment efforts. This is in addition to \$54.5 million that was provided to the Department in the 2006-07 budget.

Out of State Contracts. As authorized by AB 900 the Department is moving forward with its plans to transfer inmates out of state. The number of projected placements has increased from 2,260 in the Governor's Budget to 5,060 in the May Revision at an additional cost of \$9.6 million.

Update on “Prison Reforms” in the Governor’s Budget

The Administration has withdrawn several reform proposals in the Governor’s Budget and has modified three others. We had significant public safety concerns regarding the withdrawn proposals including:

- The Sentencing Commission,
- Direct Discharge of “low-level” offenders, and
- Rejecting Diagnostic Evaluations.

Updated proposals include:

- **12 Month Discharge.** A savings of \$31.2 million is projected by implementing a policy of discharging parolees after 12 months of “clean time”. We still have public safety concerns about implementation of this policy.
- **Juvenile Population Shift.** A further savings of \$7.2 million due to a recalculation of the population to be shifted and updating the savings to the state using updated numbers.
- **California Adult Probation Accountability and Rehabilitation Act.** Funding for this program is reduced from \$50 million in 2007-08 and \$100 million in 2008-09 to \$25 million.

Capital Outlay

Lethal Injection Chamber. The May Revision proposes \$182,000 for construction of the Lethal Injection Chamber at San Quentin in addition to the \$400,000 already redirected. This project has been the subject of a Senate Committee on Public Safety hearing.

Unfunded Budget Year Needs

While the Department’s budget is increasing by \$113 million in the May Revision, this does not include the following cost pressures, which could potentially add up to another \$200 million to the Department’s budget.

Lack of Staff for Prison Construction. The Department will be embarking on a expansive building program as a result of the passage of the Public Safety and Offender Rehabilitative Services Act of 2007 (AB 900), including building 40,000 new state prison beds. The May Revision contains only four positions related to this expansion. Inevitably, more positions will be needed to provide adequate oversight and to handle the workload associate with this program. Without adequate staffing the department will not be able to carry out the mandates of AB 900, which could lead the federal courts to impose a population cap.

The May Revision does propose \$2 million for the Corrections Standards Authority to administer the local jail bed construction component of AB 900, which appears to address this need.

Health Care Receiver. The May Revision also does not contain funding for all of the activities of the Prison Health Care Receiver, imposed in the *Plata v. Schwarzenegger* litigation surrounding prison health care. These costs were not submitted by the Receiver in a timely manner, and as such are not included in the May Revision. This is another indication that the Receiver is not willing to work within the state’s existing systems. In a letter dated May 11, 2007 the Receiver states a funding need of \$150.6 million. Due to the extraordinary powers granted to the Receiver by the courts in this litigation, failing to fund the requests of the Receiver could lead to him “backing up the Brinks Truck”.

The May Revision does propose to increase the unallocated amount available to pay for the Receiver’s actions from \$150 million to \$175 million. This money is to be used to address needs for other class action lawsuits if the parties agree to a need. It is not clear how all of these budget requests interact.

Transportation

Revised Proposition 1B Initial Allocation. The Highway Safety, Traffic Reduction, Air Quality, and Port Security Bond Act was passed by the voters in November 2006. The bond authorized \$19.9 billion of General Obligation Bonds for various transportation related purposes. The Governor's May Revision proposes to appropriate \$11.5 billion to begin the implementation of the transportation bonds. This is an increase of \$3.8 billion from the Governor's Budget. Of this amount, only \$4.1 billion is projected to be allocated or committed in 2007-08. The initial allocation and appropriation amounts will be adjusted as programs are more fully developed and projects are approved. The remaining \$7.4 billion would be allocated in 2008-09 and 2009-10.

Until criteria are approved for specific programs and projects are identified, the appropriation of bond funds for allocation beyond 2007-08 may be premature and inhibit the Legislature's ability to make informed decisions about transportation bond fund spending. A more prudent approach may be to provide limited additional spending authority through budget bill language to allow the Department of Transportation to spend additional funds to start projects that are justified through legislative notification.

This chart represents the Governor's May Revision Planned Proposition 1B Implementation:

Planned Proposition 1B Implementation (Dollars in Millions)				
	Budget Bill Appropriations			Total Three Year Appropriations
	<u>2007-08</u>	<u>2008-09</u>	<u>2009-10</u>	
Corridor Mobility	\$610	\$1,577	\$1,229	\$3,416
Transit	\$600	\$350	\$350	\$1,300
State Transportation Improvement Program	\$739	\$799	\$274	\$1,812
Local Streets and Roads	\$600	\$300	\$150	\$1,050
Trade Infrastructure	\$202	\$302	\$302	\$806
State Highway Operation and Protection Program	\$405	\$267	\$24	\$696
State/Local Partnership	\$202	\$197	\$200	\$599
Grade Separations	\$123	\$123		\$246
Highway 99	\$16	\$109	\$302	\$427
School Bus Retrofit	\$97	\$97		\$194
Local Seismic	\$14	\$11	\$11	\$36
Air Quality Improvement	\$111			\$111
Port, Harbor, and Ferry Terminal Security	\$178	\$123	\$101	\$402
Intercity Rail	\$190	\$74	\$128	\$392
Total Appropriations	\$4,087	\$4,329	\$3,071	\$11,487

Capital Outlay Support Staffing. The May Revision proposes to increase the capital outlay support program and bond-related workload by a net increase of \$206 million and 527 positions. Of the \$206 million, \$132 million will be for contract positions and cash overtime to complete bond-related workload representing approximately 95 percent of the total bond work. The additional \$74 million base increase will fund salary increases for existing positions, operations, equipment, and additional contracts. Support levels will slightly increase through 2010 and declining significantly thereafter.

Overall, the 13,121 proposed staffing level consists of 85 percent state staff and 15 percent contract staff for the entire capital outlay support and bond-related activities. Non-bond related activities are

decreasing with the reduction of 100 vacant state positions and 13 contract positions to reflect a lower level of anticipated ongoing workload.

Public Transportation Account (PTA) Funds. The PTA receives funds from sales tax on diesel fuel, a portion of the sales tax increase provided by Proposition 111, Proposition 42, and the “spillover” sales tax on gasoline. Current law contains an arcane formula that requires the General Fund to transfer sales tax revenues to the PTA under specified conditions. This transfer is often triggered during periods of high gasoline prices and is used to fund rail and mass transit projects. Due to high gasoline prices there have been “spillover” revenues for the past five years and the May Revise revenues are estimated to be \$827 million in 2007-08. This is a \$210 million increase from the Governor’s Budget and \$200 million of these funds will be used to reimburse the General Fund for the Home-to-School Transportation Program pursuant to Control Section 24.80 which specifies that funds derived from the Public Transportation Account are to be used for mass transportation purposes and this program is a component of the state’s mass transportation program.

The Governor’s May Revise proposes to reallocate spillover/PTA funds to reimburse and offset General Fund expenditures in the following transportation programs:

Spillover/PTA Funds	
<u>2006-07</u>	
Home-to-School Transportation	\$200 million one-time
<u>2007-08</u>	
Home-to-School Transportation	\$633 million on-going
Transportation General Obligation Debt Service	\$340 million one-time
Developmental Services-Regional Center Transportation	\$129 million one-time

The May Revise indicates that spillover revenues are projected to grow to \$935 million in 2008-09, therefore, the PTA should be able to offset an additional \$200 million General Fund in 2008-09 while providing at least \$100 million for program growth in the PTA.

Motor Vehicle Account Going Insolvent. The Motor Vehicle Account (MVA) is rapidly declining with projected shortfalls of \$147 million beginning in 2009-10, \$361 million in 2010-11, and \$524 million in 2011-12. Excluded from this estimate are new spending pressures such as REAL ID, DMV IT upgrade projects, and public safety enhancements. The May Revise indicates that a working group of affected agencies will continue to look at the cost trends and future program needs, savings measures, and funding options including potential ***new funding sources*** (i.e. fee increases) to ensure the solvency of the fund. Given these concerns, it does not seem prudent for the Governor to propose the MVA to loan \$15.9 million to implement AB 32 (Nunez/2006).

Resources, Environment and Energy

Fee Increases. Last year, Republicans were successful in removing many of the fee increases proposed in the budget bill. Generally, fee increases are harmful because such policies tend to impede economic development.

The Governor's May Revise includes an additional fee increase of \$438,000 for the Board of Pilot Commissioners. This amount would be generated by an increased operational surcharge, pilot trainee surcharge, and serving pilot fee. The fee increase is needed to fund additional pilot trainees and is supported by the industry.

Flood Protection

Initial Bond Allocations. Proposition 1E, Flood Prevention and Drinking Water Protection Act of 2006 was passed by the voters in November. In addition, the voters approved Proposition 84, the Safe Drinking Water, Water Quality and Supply, Flood Control, River and Coastal Protection Bond Act. The Governor's May Revise (April Finance Letter) proposes an additional \$176.5 million from Prop 1E and 84. The majority of this increase is to backfill the proposed reversion of AB 142 (Nunez/2006) General Funds (See Revert AB 142 below). Total proposed funding for 2007-08 is \$806 million from Proposition 1E, Proposition 84, and Proposition 13 bond funds and AB 142 (Nunez/2006).

Revert Levee Repair Funds (AB 142). The Governor's May Revise (April Finance Letter) proposes to delete the \$200 million transfer of Proposition 1E bond funds to repay the General Fund for expenditures incurred under Assembly Bill 142 (Nunez/2006). Instead the May Revise (April Finance Letter) proposes to revert \$168 million in unspent AB 142 (Nunez/2006) General Funds and \$16 million from unspent Flood Control Subventions Program General Funds for a total of \$184 million. An additional \$168 million in Proposition 1E and 84 are proposed to backfill the General Fund reversions and fund sediment removal, capital outlay projects, local assistance grants for levee repairs, and new feasibility studies and levee evaluations that would have been funded with AB 142. The reversion of General Fund monies for critical flood infrastructure projects is not a prudent decision given the fact that there will be a greater need for flood protection work than the current bonds funds will be able to sustain. Furthermore, these were "pay as you go" funds that would save the taxpayers millions in financing costs.

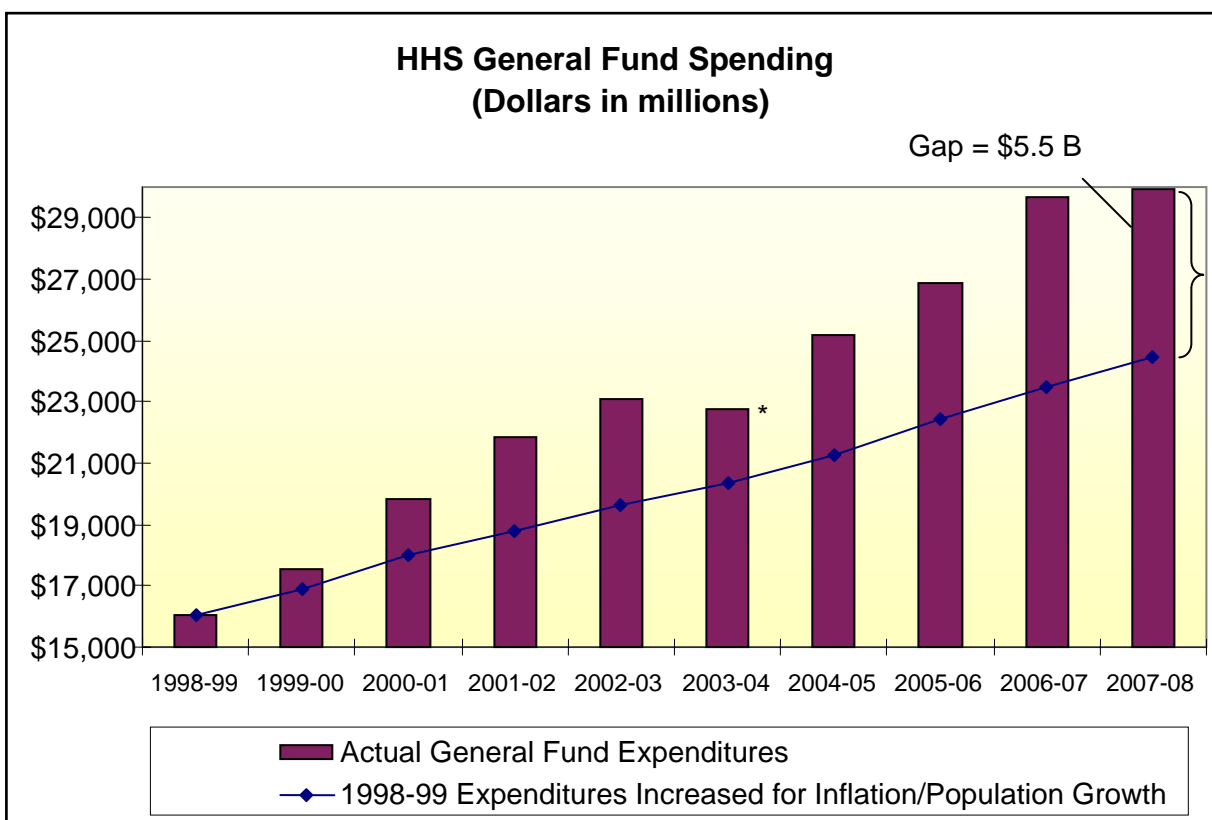
Trade Corridors Emission Reduction Incentive Program. The Governor's May Revise proposes to appropriate \$111 million in Propositions 1B bond funds to implement the Trade Corridors Emission Reduction Incentive Program (See Proposition 1B Implementation Chart). Under Proposition 1B, the Air Resources Board (ARB) is authorized to spend a total of \$1 billion on projects that improve the air quality in California's major trade corridors. The ARB will give priority to projects that provide the greatest lifetime emissions reduction in each corridor for each dollar invested.

Health and Human Services

The Governor's May Revise proposes expenditures of \$29.9 billion General Fund for all of Health and Human Services in 2007-08. This represents an increase of \$32 million over the Governor's January Budget, and an increase of \$239 million, or 0.8 percent, above the revised 2006-07 level.

The May Revise contains several new proposals, including increased General Fund expenditures of \$107.1 million related to a new rate methodology for Medi-Cal managed care plans and General Fund savings of \$184.7 million for suspending the January 2008 Supplemental Security Income/State Supplementary Payment Program's cost of living adjustment. The May Revise also continues the Governor's Budget program reform proposals that would result in General Fund savings of \$1 billion with changes to the CalWORKS Program (\$438 million), Child Care (\$269 million), and one-time savings from using Public Transportation Account funds to support Regional Center transportation services (\$129 million).

Despite these proposed savings, Health and Human Services **General Fund expenditures** are still **\$5.5 billion above** what they would have been **had programs grown at the same rate as inflation and population**. Certain programs, such as Medi-Cal, EPSDT, Regional Centers, In-Home Supportive Services, and Healthy Families continue to grow at significant rates, yet the Administration proposes no meaningful reforms to control future costs in these programs. California cannot continue to fund these programs within its current revenue stream without substantial, long-term programmatic reforms.

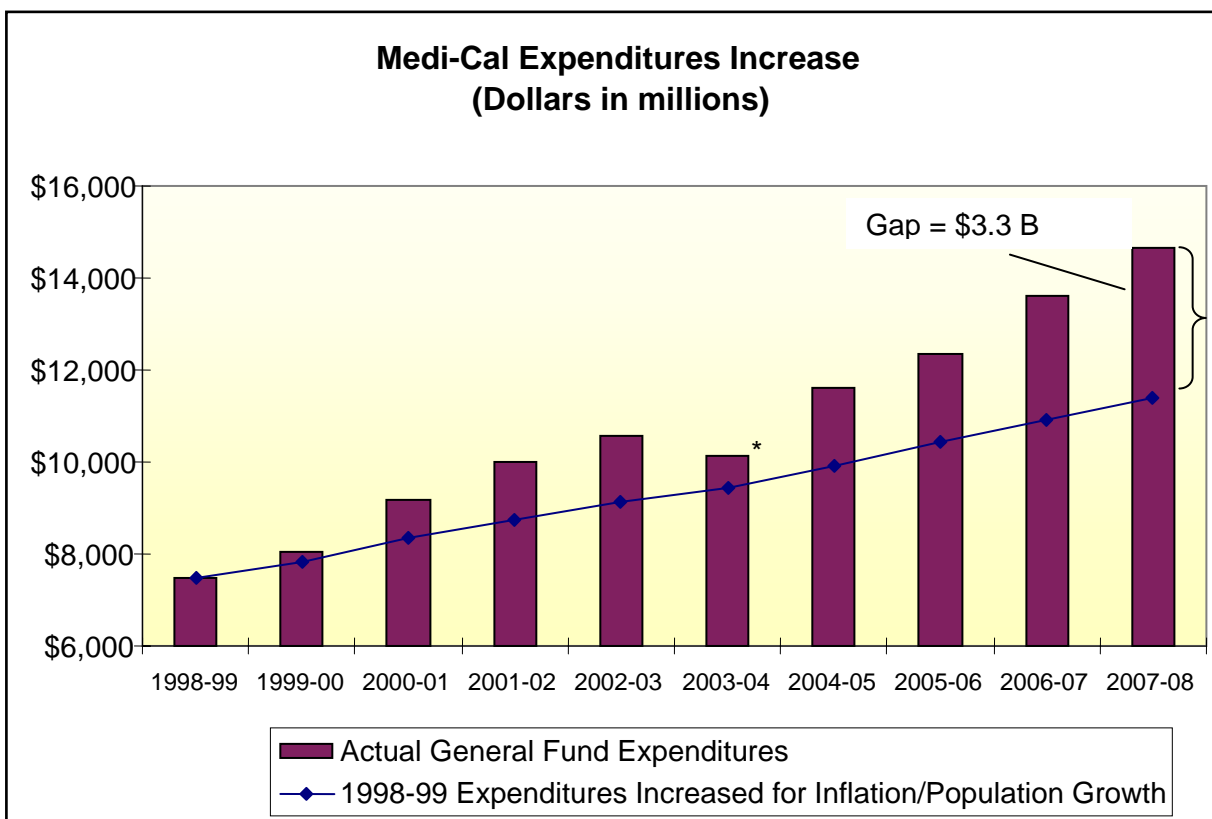


* The 2003-04 General Fund reflects one-time savings for accrual-to-cash accounting (\$1 billion) and enhanced federal fiscal relief (\$566.1 million) in the Medi-Cal program.

Health

Department of Health Care Services

Medi-Cal. The May Revise includes \$37.7 billion (\$14.7 billion General Fund), which reflects an increase of \$330.3 million (\$39.4 million General Fund), or 1 percent, above the Governor's Budget, and \$1 billion, or 7.6 percent, above the revised 2006-07 level. The General Fund increase primarily reflects increased service costs per beneficiary. Expenditure growth is considerably higher than the projected caseload growth of 1.1 percent, and the gap between actual General Fund expenditures and what expenditures would have been had they grown at the same rate as inflation and population continues to grow. As noted below, this gap will be \$3.3 billion in 2007-08.



* The 2003-04 General Fund reflects one-time savings for accrual-to-cash accounting (\$1 billion) and enhanced federal fiscal relief (\$566.1 million) in the Medi-Cal program.

The May Revise contains several significant new proposals, including:

The Trifecta (Undocs, Abortion, and No Parental Notification) - State Only Funding of Medi-Cal Minor Consent Program: The May Revise includes an increase of \$18.9 million General Fund for the Medi-Cal Minor Consent Program due to the loss of matching federal funds for pregnancy-related services. The state is losing its federal match because it plans to exempt Minor Consent beneficiaries from presenting evidence of citizenship and identity, as required by the federal Deficit Reduction Act of 2005 (DRA). The current Minor Consent Program excludes parental income and resources from consideration as a condition of Medi-Cal eligibility, prohibits contacting the minor's parents/guardians, and has never required proof of citizenship. Services provided through Medi-Cal include prenatal and postpartum services, **abortion**, family planning, and sexual assault treatment. Prior to the DRA, the only services that received a federal match were prenatal and postpartum services, which accounted for over 95 percent of Medi-Cal Minor Consent Program costs. However, the Administration does not

want to implement citizenship verification for this population because they are concerned it will be a barrier to access. As a result, ***General Fund costs will increase so that minors, regardless of immigration status, can continue to access pregnancy-related services, including abortion, without their parents' knowledge.***

Increased Managed Care Rates. The May Revise proposes \$214.2 million (\$107.1 million General Fund) for increased managed care rates related to the implementation of a new rate methodology, as recommended by Mercer Governmental Human Resources Consulting. According to the Department of Health Care Services, this new rate methodology will be plan specific, experience-based and actuarially sound, and will eliminate the use of a "budget adjustment factor," which had been used in prior years to contain costs. Although most plans will experience a rate increase under this methodology, some plans will actually see a rate reduction. However, the Administration proposes to hold these plans harmless at a cost of \$53.1 million General Fund for 2007-08 to allow for a one-year transition period.

Funding for County Implementation of the Deficit Reduction Act. The May Revise provides \$50.4 million (\$25.2 million General Fund) to support increased county workload related to the implementation of the DRA. Of this, \$25.2 million (\$12.6 million General Fund) is for one-time costs associated with the annual redeterminations. Under the DRA, applicants are required to show proof of identity and citizenship at the time of application and are not to be determined eligible until the documentation is provided; current beneficiaries are required to provide documentation at the time of their next annual re-determination and remain eligible for services so long as they are cooperative in obtaining the documentation.

Managed Risk Medical Insurance Board

Healthy Families Program. The May Revise includes \$1.1 billion (\$400.4 million General Fund), which reflects an increase of \$23.8 million (\$8.2 million General Fund), or 2 percent, above the Governor's Budget, and \$98.3 million (\$38.2 million General Fund), or 9.7 percent, above the revised 2006-07 level. This high rate of growth is attributable to caseload growth of 8.9 percent and a 3.1 percent increase in the average monthly capitation payment for health, dental and vision services.

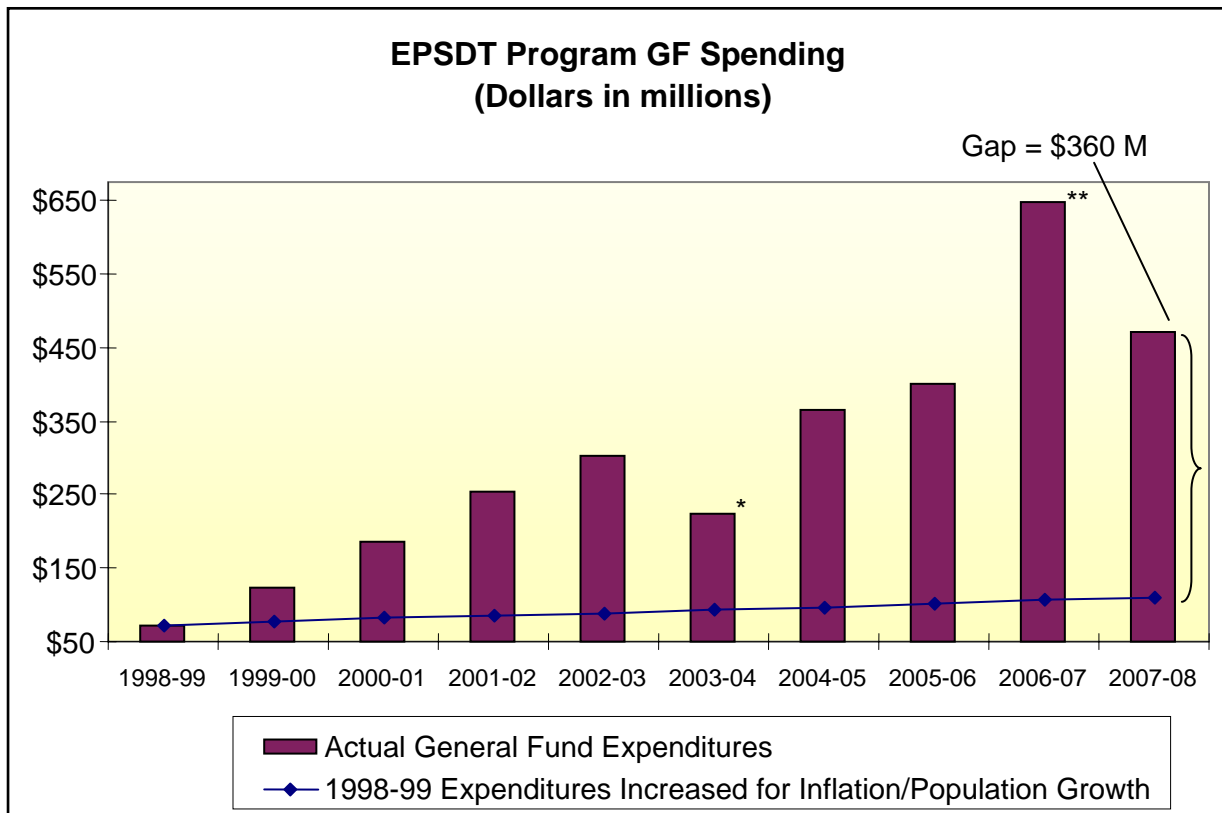
New Presumptive Eligibility Program. The May Revise proposes to replace the Healthy Families to Medi-Cal Bridge with a presumptive eligibility program because the Bridge Program no longer qualifies for federal financial participation. The Bridge Program had been approved as part of a waiver that expired January 2007, and the program could only be re-authorized if the state agreed to federal/state cost sharing of 50/50, rather than 65/35, retroactive to 2002. Under this scenario, the state would have owed the federal government approximately \$2.9 million. The Bridge Program provided children with two additional months of Healthy Families coverage when a child's household income fell below the eligibility requirements, while the proposed presumptive eligibility program would dis-enroll the child from Healthy Families, and instead provide Medi-Cal coverage until a final eligibility determination were made. This final eligibility determination would likely take longer than two months, as the revised Medi-Cal Estimate assumes that participants in the presumptive eligibility program would receive coverage for an average of 5 months. The May Revise estimates that the cost of the proposed presumptive eligibility program would be approximately \$4 million, which is roughly the same as the current Bridge Program.

Access for Infants and Mothers Program. The May Revise proposes \$133.2 million (\$8.3 million General Fund) for the Access for Infants and Mothers Program, which is a reduction of \$5.5 million in total funds from the Governor's Budget, but an increase of \$8.3 million General Fund. This program had previously been supported entirely by subscriber contributions, Proposition 99 funds, and federal funds. However, because of lower than anticipated Proposition 99 revenues, the Administration is proposing to backfill the reduction in Proposition 99 funds with General Fund. This proposal is noteworthy because the Administration could have reduced other Proposition 99-funded programs, such as the California Healthcare for Indigents Program, instead of increasing General Fund expenditures.

Department of Mental Health

The May Revise proposes total expenditures of \$4.9 billion (\$1.95 billion General Fund), an increase of \$111 million (\$22.2 million General Fund), or 2.3 percent above the Governor's Budget, and an increase of \$1 billion (\$75 million General Fund), excluding a prior year deficiency request related to the EPSDT Program, over the revised 2006-07 levels. The year-to-year General Fund increase is approximately 4 percent, while total expenditures are estimated to increase by almost 26 percent due mainly to increased Proposition 63 revenue. Approximately \$29 million of the increase from Governor's Budget to May Revise is due to the reappropriation of Lease Revenue Bond funds for a capital outlay project at Patton State Hospital. Other notable changes since the Governor's Budget include:

EPSDT Program Increases. The May Revise indicates that the Early, Periodic Screening and Treatment Program (EPSDT) will increase by \$32 million General Fund, or 7 percent, over the Governor's Budget. This increase is primarily due to a revised estimation methodology. The May Revise makes no adjustments to the current year deficiency request of \$302 million General Fund. Notwithstanding the deficiency request or the change to methodology, the EPSDT program will continue to significantly increase, growing by over 8 percent in 2007-08. Although General Fund expenditures in this program have grown by over 500 percent since 1998-99 and have almost doubled since 2003-04, the May Revise proposes no reforms to contain this significant growth. The gap between actual General Fund expenditures and 1998-99 expenditures grown at the rate of population and inflation will be \$360 million in 2007-08, as noted below.



* The 2003-04 General Fund reflects one-time savings for accrual-to-cash accounting (\$1 billion) and enhanced federal fiscal relief (\$566.1 million) in the Medi-Cal program.

** The 2006-07 number includes a \$242 million prior-year deficiency request.

Court-Driven Salary Increases for Medical Services Personnel. The May Revise includes \$42.3 million (\$41.4 million General Fund) in DMH and \$21 million (\$10.1 million General Fund) in DDS to bring salaries for classifications providing medical services to within 18 percent of the Plata and Perez court-ordered salaries and within 5 percent of the Coleman court-ordered salaries. This reflects an increase of \$44.8 million over the Governor's Budget, due to additional salary increases related to the Coleman and Perez cases. The proposed increases confirm Republican concerns that court-ordered salary increases in the CDCR would result in state departments competing with each other for the same staff through the use of salary adjustments, which not only results in increased state costs, but could lead to a new Plata court-order to further increase the CDCR's pay differential, leaving the state in the same predicament that it started in but with higher costs.

Proposition 83 - Jessica's Law. The May Revise continues to fully fund Jessica's Law, but reduces the cost to do so from \$53.9 million General Fund to \$44.2 million General Fund. These revised costs reflect updated estimates on the number of anticipated commitments in 2007-08.

Increased Funding to Alleviate State Mental Hospital Waiting List. The May Revise includes an additional \$6 million General Fund to reduce the incompetent-to-stand trial persons waiting list. Currently, there are between 250 and 300 persons waiting to enter a state mental hospital to receive competency restoration services. The Administration proposes to expand bed capacity at Salinas Valley Psychiatric Program, increase the Forensic Conditional Release Program, and contract for local beds for competency restoration services to add an additional 75 to 115 beds. If the state does not reduce the waiting list, it could be subject to court orders, contempt citations, and lawsuits.

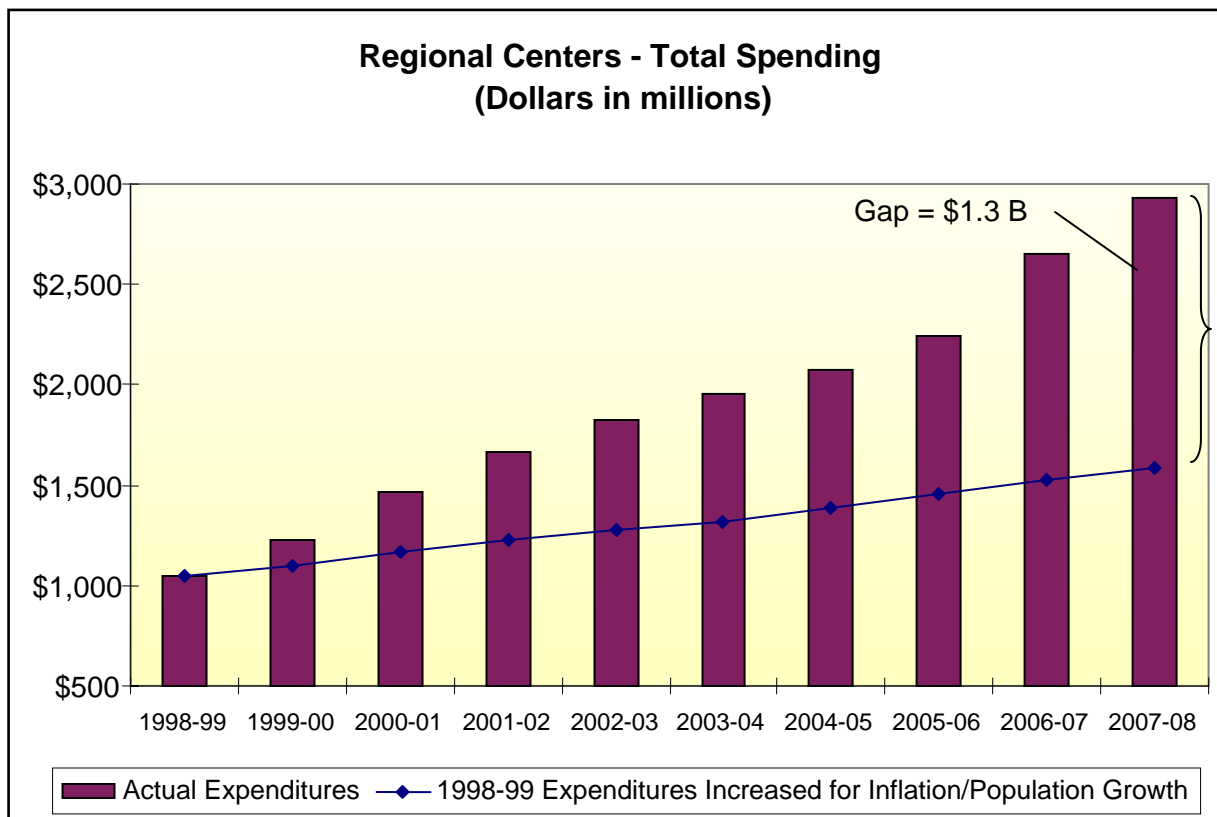
Department of Developmental Services

Developmental Centers

Closure of Agnews Developmental Center Continues to Be Lengthy and Expensive. The May Revise includes \$720.3 million (\$391.5 million General Fund), which reflects an increase of \$2.1 million (decrease of \$89,000 General Fund) from the Governor's Budget. This includes decreased costs of \$3.8 million due to developmental center unit consolidation and increased costs of \$2.6 million related to a slower than projected transfer of Agnews Developmental Center consumers into the community. The May Revise also increases the cost of State Employees in the Community (AB 1378 (Lieber, 2005)) from \$9.2 million to \$9.5 million due to the addition of 6 positions to assist the movement of state employees into the community. These increased costs and delayed movements of consumers into the community is nothing new. The closure of Agnews has already cost far more than originally anticipated: ***In 2005, DDS estimated that closing Agnews by July 2006 would cost approximately \$594 million from 2004-05 through 2009-10. Now, DDS estimates it will cost \$778 million to close Agnews by June 30, 2007, an increase of \$182 million, or 30 percent.***

Regional Centers

Regional Center Costs Continue to Outpace Caseload. The May Revise includes \$3.6 billion (\$2.2 billion General Fund), an increase of \$35.6 million (\$35.9 million General Fund) or 1 percent above the Governor's Budget, and an increase of 5 percent General Fund over the revised 2006-07 level. Absent General Fund savings of \$173 million from two fund swaps, \$129 million of which is one-time, General Fund costs would have increased by over \$280 million, a 13.2 percent increase. These increased costs are driven by increased utilization and service costs, as caseload is estimated to grow by only 3.8 percent. As illustrated by the chart below, total Purchase of Services costs have increased dramatically. ***Despite this significant growth in costs, the May Revise does not include any long-term reforms to reduce the rate of growth in this program.***



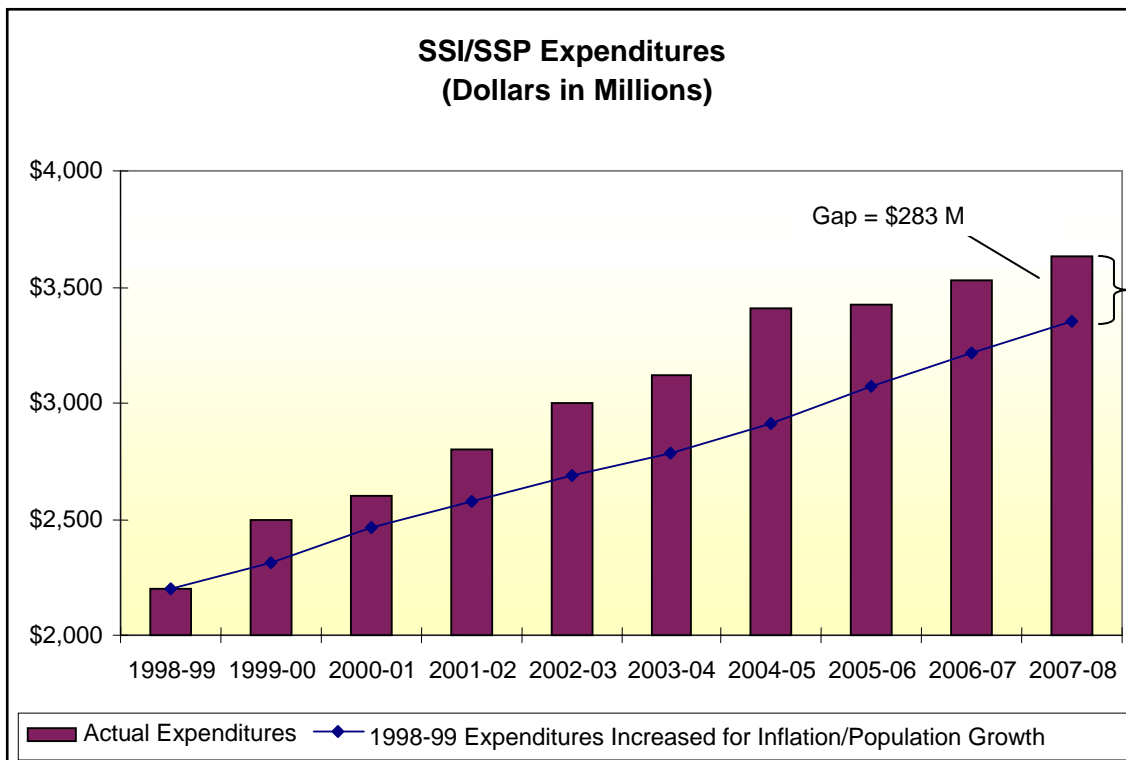
Human Services

Department of Social Services

CalWORKs. The Governor's May Revision provides \$7 billion total funds for California Work Opportunity and Responsibility to Kids (CalWORKs) programs, consistent with the Governor's January Budget. Caseload is expected to be 404,300 in 2007-08, which represents a decrease of 63,659 recipients or 13.7 percent *below* the Governor's January Budget.

- **Reform Proposals Continue.** The Governor's May Revision continues to assume savings from the CalWORKs program reform proposals originally included in the Governor's January Budget, although with a slight reduction in projected savings. The May Revision assumes \$9.9 million in savings erosion due to caseload projections and methodology changes in implementing full family sanctions, modifications to the safety net program, and the establishment of time limits for families with drug felons and other ineligible adults. Total savings assumed in 2007-08 are now \$438 million General Fund.

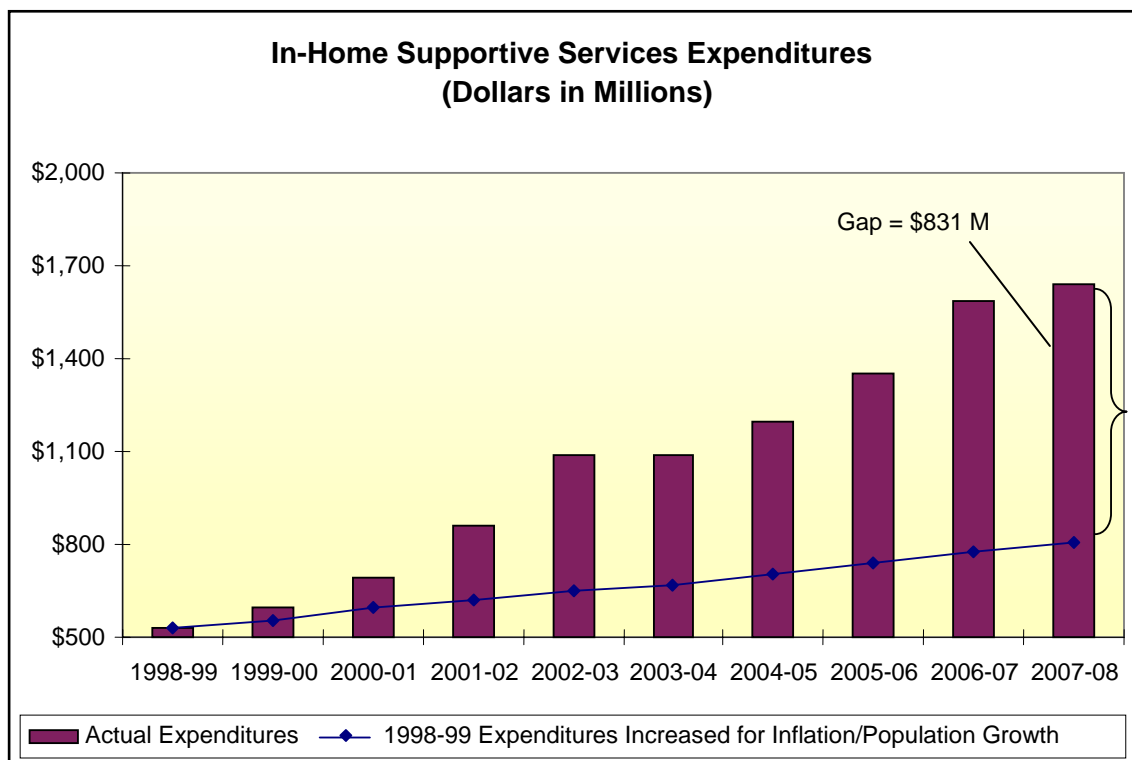
Supplemental Security Income/State Supplementary Payment (SSI/SSP). The Governor's May Revision proposes \$3.6 billion General Fund for SSI/SSP in 2007-08, a decrease of \$262.3 million General Fund below the Governor's January Budget. As is evident in the table below, SSI/SSP expenditures continue to exceed the costs that would be incurred if it grew at the same rate as inflation and population.



Suspend January 2008 Cost of Living Adjustment. The Governor's May Revision proposes to suspend the January 2008 state cost of living adjustment (COLA) in the SSI/SSP program, resulting in savings of \$184.7 million in 2007-08, and ongoing savings of \$369.5 million in future years. The Administration continues to propose to pass through the January 2008 federal COLA, which will increase grants slightly. ***Even with the suspension of the COLA, California's grant levels are projected to remain some of the highest in the nation.***

In-Home Supportive Services (IHSS). The Governor's May Revision proposes \$1.6 billion General Fund (an increase of \$85.6 million General Fund above the Governor's January Budget) for the IHSS program in 2007-08. The caseload is estimated to be 389,100 recipients in 2007-08, a decrease of 6,000 recipients from the Governor's January Budget.

Even with a reduction in caseload, program costs once again increase above the January Budget, and as is evident in the chart below, continue to greatly exceed the costs that would be incurred if it grew at the same rate as inflation and population.



- **Reform Proposal Continues But Costs Spiral Upwards.** Although the Governor's May Revision continues to propose a wage freeze for IHSS providers, the budget **does not** take any additional steps to stem the quickly rising costs of the IHSS program and in fact funds wage increases negotiated at the local level since the release of the Governor's January Budget. General Fund costs for the recently negotiated wage increases are \$35.7 million in 2007-08. If statutory changes are not implemented immediately, counties will continue to negotiate higher wages and the state will be forced to pay for those wage increases.
- **Savings Fail to Materialize from Quality Assurance Program.** The Governor's May Revision includes an increase of \$48.5 million General Fund as a result of lower than projected savings from the IHSS Quality Assurance Program. This is a **53-percent reduction in projected savings**, due to delayed training and fraud coordination investigations, and a delayed implementation schedule at the county level. As the state is currently spending about \$10.2 million General Fund on resources for this program, any further reduction in savings would result in a negative cost/benefit ratio of the program and a corresponding reduction in staff resources should be considered at that time.

Child Welfare Services (CWS). The Governor's May Revision includes expenditures of \$4 billion (\$1.6 billion General Fund) in 2007-08, an increase of \$17.8 million General Fund compared to the Governor's January Budget. Caseload for all CWS programs is projected to increase by 3.4 percent in 2007-08.

- **Rate Proposal for Dual Agency CWS Children.** The Governor's May Revision includes a proposal to establish statewide consistency for rates paid for CWS-eligible children that are also eligible to receive services from the Department of Developmental Services. The Administration proposes to establish a standard monthly rate of \$2,006 for adoption and foster care payments. Establishment of the standard rate would result in cost avoidance of \$7.1 million General Fund in 2007-08, with net annual cost avoidance projected to increase to \$45.8 million General Fund in future years.

- **Guaranteed Annual County Pay Increases.** Chapter 75, Statutes of 2006 (AB 1808) required the Department of Social Services (DSS) to submit a plan for developing a new method of budgeting county costs for child welfare services. The Governor's May Revision includes trailer bill language that would provide an annual adjustment, beginning in 2008-09, to county administration funding equivalent to the salary and benefit increases provided to state employees. Any proposal that provides a statutorily required annual increase for county costs severely limits the state's flexibility in building future budgets and will commit the state to General Fund expenditures that may not be sustainable with current revenues.

Big Bucks for County Welfare Departments. AB 1808 also required the DSS to estimate the costs for county administration of human services programs using county cost data, and include those estimated costs in budget documents beginning with the 2007-08 May Revision. Although the Governor's May Revision does not include additional funding for the county cost of doing business adjustment, based on unverified county cost data, the projected fiscal need is roughly \$460 million in state funds (General Fund and Temporary Assistance for Needy Families). Requiring the counties' fiscal estimates to be included in budget documents results in severe pressure on the state to annually fund unverified county cost data.

General Government

Tribal Gaming Revenues. The May Revision adjusts expected General Fund revenues resulting from new tribal gaming compacts from \$505.9 million to \$313.5 million. This assumes ratification of the compacts by May 15, 2007. The Department of Finance estimates that each day of delay after that date results in a revenue loss of \$1.26 million. The LAO estimates that these revenues are too high by \$184 million.

California Gambling Control Commission. The May Revision proposes \$1.7 million Indian Gaming Special Deposit Fund to establish an audit and compliance unit to review and enforce minimum internal control standards.

Department of Veterans Affairs. The May Revision includes \$3.3 million for the new 75-bed Alzheimer's Unit at the Veteran's Home in Yountville, expected to open in mid-July 2007. Also included is an increase of \$1.2 million for a 40-bed Skilled Nursing Facility expected to open in January 2008.

Williamson Act Subsidies. The Governor's May Revision proposes a **decrease of \$39.1 million** in General Fund spending associated with the **elimination of Williamson Act subsidies**. These subsidies partially backfill property tax revenue that local governments forfeit when they enter into contracts with landowners to not develop land in exchange for reduced property tax assessments. The Governor's justification for the reduction of state General Fund is that property tax revenues have grown at a stronger rate than General Fund revenues and therefore, these subsidies are no longer necessary to maintain the fiscal integrity of local governments. However, Republicans would likely be opposed to this reduction since it could lead to an elimination of the program by the local governments which would negatively affect farmers and their ability to keep agricultural lands in production.

Secretary of State. The May Revision includes \$11.7 million General Fund to fund the costs associated with the February 2008 Presidential Primary Election, which was authorized by Chapter 2, Statutes of 2007 (SB 213/Calderon). These costs include ballot preparation and printing, voter registration, voter participation, the voting process, and election night reporting. Consistent with SB 213, the state will reimburse counties for their costs associated with the election.

Statewide Issues

Augmentation for Employee Compensation. The Governor's May Revision includes \$24.1 million for salary increases required under current contractual obligations. This includes increases for the Highway Patrol, engineers, as well as general growth in state employees and an increase for health care contributions. However, the revised budget does not include additional funding for Correctional Peace Officers (Bargaining Unit 6) as the Administration continues to negotiate for a new contract, but to no avail. If an agreement can be reached, costs could easily exceed \$330 million, which would need to be funded out of the reserve.

CalPERS - Health and Dental Benefits. The Governor's May Revision assumes savings of \$15.3 million General Fund for reduced health care premiums for both current employees and retired annuitants. This assumption assumes a level of risk as the CalPERS Board has not yet taken action on proposals that would result in the reduced premium levels (from 12 percent assumed in the January Governor's Budget to 10 percent assumed in the May Revision). CalPERS staff has recommended increasing co-payments for office visits, emergency room visits, and prescription drugs.

- **Government Standards Accounting Board (GASB).** States must now determine and report the long term costs of non-pension benefit costs, which usually consist of health care coverage, dental coverage, vision coverage, life insurance, and long term care. These are often referred to as "other post employment benefit obligations." In a report released by the State Controller's Office (SCO) the ***state's total unfunded liability for state retiree health benefits is \$47.88 billion***, which represents the total present value of future retiree health benefits for current state retirees and employees. This estimate does ***not*** include the University of California. If CalPERS fails to take action on the proposals that would result in reduced premium increases, proposed growth in premium costs will be inconsistent with those assumed by the SCO, which would increase the amount of the state's unfunded health and dental obligation.
- **Post Employment Benefits Commission.** Last fall, the Governor created the Post Employment Benefits Commission to examine what is owed in unfunded pension and other post-employment benefits, and to recommend how to meet those obligations as they become due. The Commission will report to the Governor and the Legislature by January 1, 2008, on the size of the liabilities and propose a plan to address those obligations. The Administration has not proposed any significant budget actions to reform the state's retirement system or to address the health and dental obligations, and indicates they will wait until the Commission has submitted their report in January 2008 before recommending any policy changes.

Pension Obligation Bond. The Governor's May Revision postpones the issuance of the pension obligation bond until 2008-09, resulting in increased General Fund obligations of \$525 million in 2007-08. The proposal acknowledges a strong legal challenge, but the Administration is still optimistic that they will prevail on their upcoming appeal, to be heard June 2007. However, it is not realistic to expect that the court of appeals will overturn the November 2005 ruling, which found that pension obligation bonds are unconstitutional without voter approval. It would probably be best if the Administration would simply concede on this idea.

Control Section 15.25 Technology Rates. The Governor's May Revision proposes a new control section authorizing the Director of Finance to adjust department budgets to reflect rate changes adopted by the Technology Services Board in January 2007 and any additional rate changes that may be adopted in subsequent years. The new rates are expected to result in savings of \$26.7 million statewide. The Administration indicates that any additional rate changes in 2007-08 would be cost neutral.

Leasing the Lottery

The May Revision **does not propose a detailed plan** to “privatize” or lease out the operation of the California Lottery. What they have done is propose that the Lottery **could** be leased to a private concessionaire, who **could** increase sales at least to the national average, which **could** result in a significant financial benefit to the state. The Department of Finance indicates that over the past few months they have received numerous proposals from investment banking firms identifying the potential benefits associated with leasing the California State Lottery to a private entity. These proposals range from an aggressive \$37 billion up-front lump-sum payment to a more conservative \$8 billion up-front lump-sum payment.

Under all of the options, the Administration believes that leasing the lottery could generate a significant up-front pot of money to maintain education funding (at approximately \$1.3 billion annually), pay off the Economic Recovery Bonds (approximately \$8 billion), fund new pay-as-you-go capital outlay projects, and **many other options**. Leasing the lottery and paying off the ERBs would free up approximately \$1.6-1.7 billion annually of sales tax revenue (from the triple flip) currently spent on debt service, as well as providing increased annual revenue of approximately \$300 million from resultant corporation income taxes. No details regarding this “scheme” have been discussed yet, but the Administration believes there should be two priority uses for those funds, including:

- Guarantee that education continues to receive the same dollar level of funding that it received in the highest year of lottery funding (approximately \$1.3 billion).
- One-time proceeds should be used to retire existing state debt (Economic Recovery Bonds).

Issues for Consideration. At best, this is a “what if” proposal that provides very little detail. This will likely result in complex discussions that will encompass many of the issues noted below.

- **Use of One-time Proceeds.** Some may see the Lottery as an endless pool of money from which to draw. Throwing this question open to the political process in the Legislature, as the Administration proposes, could lead to Lottery revenues becoming a “Christmas Tree” for various non-education related interests.
- **Voter Participation.** Proposition 37, the California State Lottery Act of 1984, was approved by the voters at the November 6, 1984 general election. The question becomes, is it necessary to go back to the voters to approve this institutional change in the way the Lottery works? Part of the proposal is to **use Lottery proceeds for purposes other than education funding**. This was not contemplated as part of the original Lottery Act and, at one time, the Administration believed that it would have to go back to the voters for approval.
- **Education Funding.** The Legislature would need to consider the appropriate level of short- and long-term funding and how that funding would be provided. This is also a major departure from the original intent of the Lottery Act as adopted by the people in 1984.
- **What is the Lottery Worth?** If this project moves forward, the Legislature would need to establish parameters for a transaction to be completed, including a minimum upfront payment and/or minimum levels of annual payments from the concessionaire.
- **Effect on Other State Revenue Sources.** It is likely that a privately run lottery would have (both positive and negative) on other state revenues, including revenues from tribal casino, sales taxes, and income taxes.

Conclusion. Thus far, there are more questions than answers and nothing can be answered until concrete proposals from the Administration are provided. Considering the quintessential change to the whole purpose of the Lottery that is being proposed, perhaps it is best to seek the wisdom of the voters on a specific proposal. Additionally, putting the question to the people avoids potential litigation and may provide higher yield.

Senate Republican Fiscal Staff Assignments

Seren Taylor, Staff Director
(916) 651-1501

Laurie Hall, Budget Committee Assistant
(916) 651-1501

<u>Assignment Area</u>	<u>Consultant</u>	<u>Phone</u>
Education	Cheryl Black	651-1501
Public Safety, Judiciary, Corrections	David Lewis	651-1501
Transportation, Energy & Environment	Rocel Bettencourt	651-1501
Health	Anissa Nachman	651-1501
Human Services, Public Employees Retirement	Chantele Denny	651-1501
Revenue, State & Local Government, Taxes	Joseph Shinstock	651-1501

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